The Federal Report

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM

The Month in Washington: October, 2008

The troubled financial sector continued to dominate government activity while the political sector readied for the endgame of a two year presidential campaign. While some decried the vast expenditure of money on campaigning, George Will reminded readers that the price tag is still less than what Americans spend annually on potato chips. Congressional committees began investigating the systemic failures in credit rating and regulation that contributed to the crisis.

Issues and Events

Bailout Broadens to Insurers, Borrowers; Critics Oppose Dividends

The massive Federal bailout of the financial sector continues to grow, prompting one lobbyist to tell reporters "Everyone has their hand out now." Insurers, car companies, and perhaps even borrowers may gain a portion of the aid package, even as data shows that its primary purpose – getting banks to lend – has not yet been achieved. The unpopular program seems to have been temporarily accepted by the public but spreading the money around in a way the public perceives as unwise could once again unleash the hostility of the public.

Reports say that the Treasury Department will use the authority granted by the bailout bill (H.R. 1424, the Emergency Economic Stabilization Act or EESA) to rescue insurers as it originally intended to aid banks. As per the arrangement with banks, the government would take an ownership stake and impose conditions that put it first in line to be repaid when the firms recover. Insurers previously shielded from this kind of turmoil by the McCarran-Ferguson Act and other laws that divided banking from insurance, became involved in more speculative business as the Congress lightened regulation during the last 10 years. Now, Treasury officials say that preventing an insurance industry collapse is needed due to the cascading effect it would have in the financial system as these guarantors against risk prove unequal to the job. The first firm rescued, American International Group (AIG), recently upped its cash needs to $123 billion, from the $86 billion initially pledged for its defense.

Elsewhere, the Federal Deposit Insurance Corporation (FDIC) negotiated with the Treasury Department about insuring troubled mortgages. The proposal would provide $50 billion to cover 3 million loans in danger of foreclosure but the final numbers could change before the agreement is finalized. The White House is said to be lukewarm on the measure, and Administration spokesman Tony Fratto said of the plan that, "We have been reviewing a number of housing proposals for some time and no decisions have been made on any of them. Any inference that we're 'nearing' a decision on any one of them is simply wrong." FDIC echoed the official line, saying through a spokesman that "While we have had productive conversations with Treasury about the use of credit enhancements and loan guarantees, it would be premature to speculate about any final framework or parameters of a potential program."

Help for borrowers, ignored in the $700 billion bailout legislation, has been a priority of both FDIC Chairwoman Shelia Blair and Senate banking Committee Chairman Chris Dodd (D-CT). "The key to our economic recovery is in addressing the root cause of this crisis -- the housing crisis," he said recently. "Federal agencies and financial institutions must do more to modify the mortgages they hold in order to stop foreclosures and help families keep their homes."

A new and potentially explosive problem arose over whether banks now in "partnership" with the taxpayers should use public money to pay dividends. Nine large banks getting $163 billion from the taxpayers plan to spend about half of the money on dividends, prompting outcries from Congress. "The whole purpose of the program is to increase lending," said Senator Chuck Schumer (D-NY), a prominent member of the Senate Banking Committee. "If the money is used for dividends, it defeats the purpose of the program." But some experts contend that the program has a dual purpose in both rescuing troubled banks and also providing capital to healthy ones so that they can expand, and that the second of these goals requires investors who can be drawn by solid dividends. Ed Yingling of the American Bankers Association said of the dichotomy, "The government really needs to make up its mind [about] what this program is."

The announcement that the Federal Reserve also extended $120 billion to the central banks of Mexico, Brazil, Singapore and South Korea to shore up these developing economies shows that Federal generosity extends beyond U.S. territory. General Motors wants a slice of the bailout fund to smooth its merger with Chrysler, and major bond insurers want public money to offset their losses to prevent a "systemic implosion" of the financial system. Money Market funds received a $540 billion guarantee from the Federal Reserve on October 21.

Credit Rating Agencies "A Story of a Colossal Failure" …

The House Oversight and Government Reform Committee held a hearing on October 22 on the role of credit rating agencies in the financial collapse. Many have blamed the rating industry – dominated by only three large companies – for granting suspect mortgage-backed products their seal of approval. Committee-obtained internal emails showed the agencies in a particularly poor light.

Credit raters Moody's, Standard and Poors (S&P), and Fitch were pilloried on a bipartisan basis. Committee Chairman Henry Waxman (D-CA) said "The story of the credit-rating agencies is the story of a colossal failure. Millions of investors rely on them for independent, objective assessments. The ratings agencies broke this bond of trust, and federal regulators ignored the warning signs." The Committee's top Republican, Congressman Tom Davis (R-VA), added: "Like the 'UL Approved' tag on electric appliances, an AAA credit rating is meant to insulate investors against nasty shocks. But as the collapse of the mortgage-backed securities boom has seen billions in once high-grade investments fall quickly to junk status, many are asking how and why the ... credit rating agencies got it so wrong."

The internal documents from the companies were used to full effect, showing that senior executives suspected they were not handling mortgage products properly. One email from an unnamed executive said in late 2007 that "These [rating] errors make us look either incompetent at credit analysis, or like we sold our soul to the devil for revenue, or a little bit of both." Credit rating agencies are paid by the firms that provide products for rating, and the agencies often consult with the same clients. This business arrangement causes some to believe that the raters are implicitly conflicted about offering a fair analysis, and that having customers pay for the information would better align incentives.

"When the referee is being paid by the players, no one should be surprised when the game spins out of control," Congressman Chris Shays (R-CT) observed.

In what may prove to be a multi-trillion dollar understatement, S&P CEO Deven Sharma said at the hearing that "It is by now clear that a number of the assumptions we used in preparing our ratings on mortgage-backed securities issued between the last quarter of 2005 and the middle of 2007 did not work."

Committee members continually returned to the raters' business model. Moody's Chairman Ray McDaniel told his board that "It turns out that ratings quality has surprisingly few friends: issuers want high ratings; investors don't want ratings downgrades; shortsighted bankers labor shortsightedly to game the ratings agencies." McDaniel's comments hint that, while some saw trouble ahead, cracking down on easy rating was not in the interests of those empowered to do it, and the generally loose environment meant that a competitor would simply steal the business away by maintaining its easy standards or loosening them even more.

While admitting that mistakes were made, the executives testifying before the Committee said there was no intentional harm done. Sharma of S&P said, "We have to earn our credibility back." He noted that his firm has instituted more than two dozen measures to prevent conflict of interest and McDaniel said that Moody's has increased personnel for surveillance and compliance. Stephen Joynt of Fitch's reiterated his company's commitment to greater transparency and objectivity in analysis.

In a hearing the following day (see story below), Waxman said of this hearing that "we learned that these [credit rating] firms sacrificed their rating standards – and their credibility – for short-term gains." Given the incredible scope of the catastrophe and the public's irritation at having to pay for the consequences, legislation to re-regulate the financial sector is expected in the next Congress.

… And Regulators "Asleep at the Switch"

Chairman Waxman continued the investigation into the credit collapse by bringing top regulators before the House Oversight and Government Reform Committee on October 23.

The Committee heard from former Federal Reserve Chairman Alan Greenspan, former Treasury Secretary John Snow, and current chief of the Securities and Exchange Commission (SEC) Chris Cox, and Waxman's opening statement was aimed directly at them. "Our focus today is the actions - and inaction – of federal regulators. For too long, the prevailing attitude in Washington has been that the market always knows best. The Federal Reserve had the authority to stop the irresponsible lending practices that fueled the subprime mortgage market. But its long-time Chairman, Alan Greenspan, rejected pleas that he intervene. The SEC had the authority to insist on tighter standards for credit rating agencies. But it did nothing despite the urgings from Congress. The Treasury Department could have led the charge for responsible oversight of derivatives. Instead, it joined the opposition."

Greenspan stole many of the headlines. A former object of financial worship, he admitted to some role in not foreseeing the collapse in housing prices that would trigger the landslide that has roiled the markets. He confessed to a lack of vision in not predicting a blanket collapse, saying that "people may not be smart enough" to see into the future with enough clarity to do so. He said his decisions played a part in the "once-in-a-century credit tsunami" unleashed on the markets but declined to take personal responsibility for it.

Greenspan was particularly struck that firms were unable to seek their own self-preservation. "Those of us who have looked to the self-interest of lending institutions to protect shareholders' equity, myself especially, are in a state of shocked disbelief," he said. Waxman's view of the problem is that, "Corporate excess and greed enriched company executives at enormous cost to shareholders and our economy."

On a prospective basis, Greenspan said that Congress will need to address the "too big to fail" issues brought to the fore by the market collapse, perhaps in the form of a penalty that compensates other competitors for the implicit guarantees the larger firms obtain. He noted that, aside from the wobbly $55 trillion in credit default swaps, the derivatives market was working well without regulation. The current downturn will take months to unwind and "Given the financial damage to date, I cannot see how we can avoid a significant rise in layoffs and unemployment" which "implies a marked retrenchment of consumer spending as households try to divert an increasing part of their incomes to replenish depleted assets, not only in their 401Ks but in the value of their homes as well." Home prices need to level out before any positive changes in the market can occur, according to the former Fed chief, and he recommended that, "As much as I would prefer it otherwise, in this financial environment I see no choice but to require that all securitizers retain a meaningful part of the securities they issue."

SEC Commissioner Cox said the financial system "should not be an end in itself - a baroque cathedral of complexity dedicated to limitless compensation for itself in the short-term, paid for with long-term risk capable of threatening the entire nation's sustenance and growth." He said financial regulation need a complete restructuring to create "a new, overarching statutory scheme." A former congressman, Cox recommended a select committee representing all the panels in Congress with current oversight authority to create the new regulatory regime, and blamed turf battles for the current fractured system in place today.

Waxman took a hard line, saying, "The reality is, Mr. Cox, you weren't doing the job or proposing these regulations beforehand. You didn't anticipate the problems or you agreed with the philosophy that we didn't need regulation or that the markets could regulate themselves." Congressman Tom Davis (R-VA) defended Cox, noting that "I think we all agree that there's a lot of blame to go around, but it doesn't lie with any one party or any one agency."

Former Treasury Secretary John Snow offered somewhat "left-handed" contrition. "I regret I wasn't more effective in trying to persuade Congress of the need for action to deal with the risks that I saw as the largest and -- and most visible systemic risk at the time," he said, indicating the mounting problems at Fannie Mae and Freddie Mac. Snow, joined by several GOP members of the Committee including John Mica (R-FL), attempted to steer the discussion to further examination and blame for the crisis on Freddie and Fannie, which some GOP leaders have said were a (or the) major cause of the meltdown by encouraging or mandating the creation of the subprime market. Waxman called Mica's argument a political, not a factual, one and said the Committee would examine Fannie and Freddie in due course.

The same approach recently surfaced in the House Financial Services Committee, prompting a swift response from Chairman Barney Frank (D-MA). House Republicans recently wrote to the Attorney General requesting an investigation into the role of Government Sponsored Enterprises (GSE's) Fannie and Freddie in the financial crisis. Frank released a statement that read in part: "In an unusual event, even by this year's standards, House Republicans appear to be demanding a criminal investigation of their failure to legislate. In the letter to Attorney General Mukasey, House Republicans cite among other things the fact that no legislation was adopted "for years" to reform the

GSEs. The record is very clear: the Republicans controlled Congress from 1995 – 2006, and that is the period in which the absence of regulation into which they want a criminal investigation occurred."

While Congress acted swiftly to pass legislation to deal with the credit meltdown, the long and hard fight over blame has just begun.

Second Stimulus Gains Life with Fed Chief Endorsement

Federal Reserve Chairman Ben Bernanke announced support for a second stimulus plan on October 20, breathing life into a notion long considered a non-starter because of Administration opposition and Republican skepticism.

The dire condition of the economy appears responsible for the switch in positions. "With the economy likely to be weak for several quarters, and with some risk of a protracted slowdown, consideration of a fiscal package by the Congress at this juncture seems appropriate," Bernanke said before the House Budget Committee. "The stabilization of the financial system, though an essential first step, will not quickly eliminate the challenges still faced by the broader economy," he added. Following Bernanke's statement, White House spokeswoman Dana Perino declared the President "open" to another stimulus bill.

Related National and Industry News

Final Debate Includes Retirement, Health Issues

The presidential candidates engaged in one of the more substantive debates on October 15, delving into the specifics of their positions. While the troubled economy continued to dominate the discussion, retirement and healthcare did make an appearance.

The recent plunge in the stock markets prompted Senator John McCain (R-AZ) to propose loosening the rules on when retirement assets must be drawn down. Under current law, retirees must begin taking their savings at age 70½ (the required minimum distribution, or RMD, rule), placing people of that age today in a tight spot given the diminution in value from the tumbling markets. Senator Barack Obama (D-IL) supports allowing withdrawals of up to 15% from pension accounts, up to $10,000, without triggering the customary 10% penalty.

The calls to change the RMD rules in light of recent problems in the financial system have been echoed by leaders of the House Labor Committee and House Ways and Means Committee. Labor Committee Chairman George Miller (D-CA) and Ways and Means pensions subcommittee Chairman Rob Andrews (D-NJ) wrote to Treasury Secretary Hank Paulson on October 10 urging a suspension of penalties associated with the RMD.

The current penalty for not taking a minimum distribution from a plan after age 70 ½ is 50%. Andrews offered legislation earlier this month (H.R. 7242) that would defer the RMD penalty for accounts with less than $200,000. The letter to Paulson urges relief for all account holders, however, and argues that Paulson has the authority to act without Congress, writing "We believe that you have the legal authority to effectively eliminate this penalty by not requiring the RMD for 2008. Current law requires minimum distributions over the life of the retiree. However, the Treasury regulations interpret this as requiring annual distributions. By taking action, seniors will avoid taking unnecessary losses in their retirement accounts and avoid the current excise tax. We request that you take this action immediately to help protect and rebuild the retirement savings of older Americans."

The debate also saw a sharp exchange over health care. Senator McCain said that the health plan of Senator Obama would impose fines and create a government run system. Obama countered that smaller employers would be exempt, and that no one would be forced to change the coverage they have now if they are satisfied with it. Obama's plan allows anyone to enroll in the plan for Federal employees, and requires larger employers to provide coverage or pay into a pool that pays for coverage. McCain's reform plan has four main components: competition will make coverage more affordable; consumer choice would be preserved and expanded through interstate competition; shifting coverage to workers from employees solves portability issues; and quality will be enhanced through additional research and emphasizing prevention. But Obama said that the McCain plan was a step backward and "could lead to the unraveling of the employer-based health care system" as employers lose the tax advantages that incentivize health coverage in the first place.

Candidates Unveil Dueling Economic Plans

As the economy continues to dominate the thinking of voters, both Senator John McCain (R-AZ) and Senator Barack Obama (D-IL) offered economic plans to the electorate. Both campaigns insist the enormous hole blown in the budget by economic turmoil will not affect their ability to spend hundreds of billions more.

McCain would spend about $350 billion on his economic package. The vast majority of the funds ($300 billion) would go to shore up (i.e., purchase) bad mortgages. Another chunk goes for capital gains relief by raising the deduction limit on losses from $3,000 to $15,000, and the rate would drop from the current 15% to 7.5%. Unemployment benefits would be untaxed under the belief that the government should not take back money it just handed out. McCain includes a package of retirement plan changes where savers over 59 years of age could withdraw from their accounts at a lower tax rate and suspend the requirement on those over age 70 ½ to begin selling assets and drawing down their accounts, given the enormous loss of value in the markets over the last month. McCain offers spending offsets of $300 billion.

The Obama plan gives rebates of $500 (individual) or $1,000 (family) as a prod to consumer spending and creates government funds to ease capital flow to small businesses and States, the last of which is modeled on the Federal Reserve. The plan provides $50 billion for infrastructure improvements and $60 billion in tax advantages for employers to create domestic jobs. Home foreclosures would be suspended for six months with borrowers given a chance to renegotiate their loan. Obama would also ease penalties on using retirement funds for consumption, up to $10,000 for the next 12 months. The plan claims to cost $200 billion, $90 billion of which is offset through cuts.

Study Faults Florida Medicare Program

An October 14 release from Kaiser Family Foundation reviewed the operation of Florida's Medicare program. While the program stresses competition and choice, the study found that 30% of enrollees were not fully aware of those choices, and 50% said they had trouble making a choice among the options offered.

Of the first block, a large majority said that the State had not told them of the need to choose a plan, although it is unclear if this perception stems from not getting information, not understanding the information, or not paying attention to the information. More than 40% of all participants ended up being assigned a plan by the State, undermining the central mechanic of consumer choice used by the State's revamped program. In the second group of those who understood the need for them to select a plan, more than a majority said the information was hard to understand. Compliance among those with mental or learning disabilities was even poorer.

The research suggests that there remain serious gaps in health literacy and that more outreach needs to be made to make consumers aware of their choices as well as the availability of help in making those choices. The survey authors write: "The success of consumer-choice models such as that being tested by Florida's Medicaid Reform demonstration hinge on the ability to translate complicated health-care information for consumers, and then help consumers use that information to make informed health-care decisions. Without a well-informed consumer, a fundamental piece of the competitive model is missing, jeopardizing hoped-for efficiencies and cost savings."

Florida implemented its reform plan in 2006, and Idaho, Kentucky, and West Virginia have also instituted similar reform efforts. Because many reform plans at the national level also embrace consumer choice, the learning experiences of the States informs the health reform debate to come. The States continue to lead the way in experimenting with novel ways to solve problems, and even apparent failures such as the first steps of the Florida program hopefully serve to educate policymakers elsewhere.

Regulators Renew Calls for Swap Regulation

Christopher Cox, Chairman of the Securities and Exchange Commission (SEC), called for the authority to regulate the credit default swap (CDS) market and said that Congress acting "now" would be "important" for market stability. Currently, the $55 trillion market is unregulated by law but more attention has been paid to the instruments since policymakers learned of their role in undermining AIG, the insurance giant recently taken over by the Federal government.

As a sign of the potential trouble ahead, Commodity Futures Trading Commission (CFTC) member Bart Chilton agreed with the need to regulate but believes the products should be under CFTC jurisdiction, as they have elements of futurity and fit with the other risk management derivatives overseen by CFTC.

SEC to Study Mark-to-Market

As ordered by the Emergency Economic Stabilization Act (EESA; PL 110-343), the Securities and Exchange Commission (SEC) is conducting a study of mark-to-market requirements for securities. The study should be finished in early January.

Mark-to-market mandates that investors value their securities based on recent prices, even if they have no intention of selling them anytime soon. The requirement is thought by some experts to be especially problematic for illiquid securities such as those involved in the drowning mortgage security market. Other experts, however, contend that mark-to-market merely shows junk investments for what they are, and that delaying a valuation only postpones sending information to the market that other investors should have. The study will also look at other accounting approaches to finding the elusive concept of "fair value."

Public roundtables will be part of the study process. The Financial Executives International group recently commented on the SEC initiative that "we believe the joint clarification is conceptually sound, practical, and likely to be helpful as companies strive to apply the fair value measurement standards in today's difficult markets. The historically uncharacteristic level of illiquidity in the current markets has stressed the application of the market participants model for arriving at fair value."